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Central Intelligence Agency



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**DIRECTORATE OF INTELLIGENCE**

29 February 1988

**China's Trade Tensions with Japan: Will the US Profit?** 

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**Summary**

Beijing has intensified efforts begun in 1985 to reduce imports from Japan. China's persistent bilateral trade deficit and fears of becoming dependent on Japan--which supplies a dominant share of China's imports of key industrial commodities and equipment--are the major factors causing Beijing's anti-Japanese import restrictions. But proscriptions against importing from Japan also have become a lever Beijing uses to press Tokyo on a broad spectrum of issues--ranging from Beijing's perception that Japan and Taiwan have been developing a closer political and economic relationship to fears of a resurgence of Japanese militarism and unhappiness with Japanese restrictions on technology transfer to China.

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Beijing's irritations with Japan are long-lived, in our view, but Japanese goods will remain essential to China's economic modernization program and a large Japanese market presence will remain in key sectors

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of the Chinese economy. New restrictions imposed in late 1987 suggest that in Beijing's view the onus for setting relations straight remains on Japanese shoulders. Japanese suppliers will continue to see their market share erode as a result of higher export prices resulting from the yen appreciation as well as Beijing's import restrictions. [REDACTED]

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US suppliers will gain little from the Sino-Japanese tensions, in our judgment. Chinese purchases instead appear to be moving to Western Europe, and especially West Germany. The Soviet Bloc will probably also continue to modestly increase its share of China's imports in a couple of sectors, such as steel and power generating equipment. [REDACTED]

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### Beijing's Laments

Last year, China's displeasure with its persistent trade deficit with Japan combined with its fears of Japanese economic domination to significantly sour bilateral economic relations. According to diplomatic reporting, Chinese economic officials in April told their US counterparts that Beijing was beginning a pressure campaign against the Japanese. Aware that potential problems were brewing, the Japanese requested that a Joint Sino-Japanese Economic Commission meeting be held in May--the first since 1978--to explore problem areas prior to the Fifth China-Japan Ministerial Conference to be held in late June. The meeting failed to resolve differences. Beijing remained concerned over the bilateral trade imbalance and disappointed about the low level of Japanese investment in China. For its part, Tokyo remained skeptical about Beijing's ability to expedite export shipments to Japan. Underscoring the depths of their differences, the two sides could not even agree on the statistics used to measure trade and investment flows<sup>1</sup> (see figure 1). [REDACTED]

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General Secretary Zhao Ziyang [REDACTED] in November 1987 that the trade imbalance was one of three sour points in bilateral ties, along with Tokyo's failure to intervene in a Japanese court case that awarded ownership of a disputed dormitory to Taiwan instead of China and a perceived resurgence of Japanese militarism. Chinese Customs statistics for the first nine months of 1987 suggest that China's 1987 deficit with Japan will be \$3.4 billion--down from \$7.8 billion in 1986, but still larger than China's deficit with any other country. Beijing charges Tokyo with being largely responsible for the imbalance, citing discriminatory tariffs that impose a higher tax on certain Chinese goods than on comparable imports from other countries, and import quotas on Chinese silk, agricultural commodities, and other products. [REDACTED]

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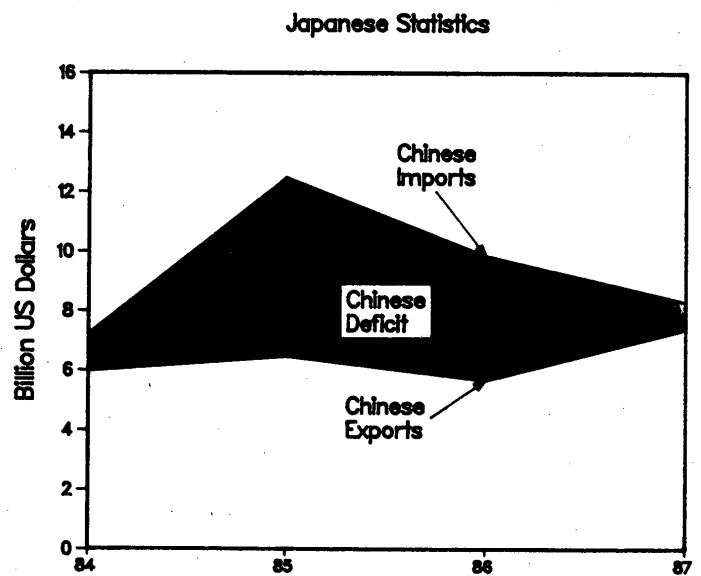
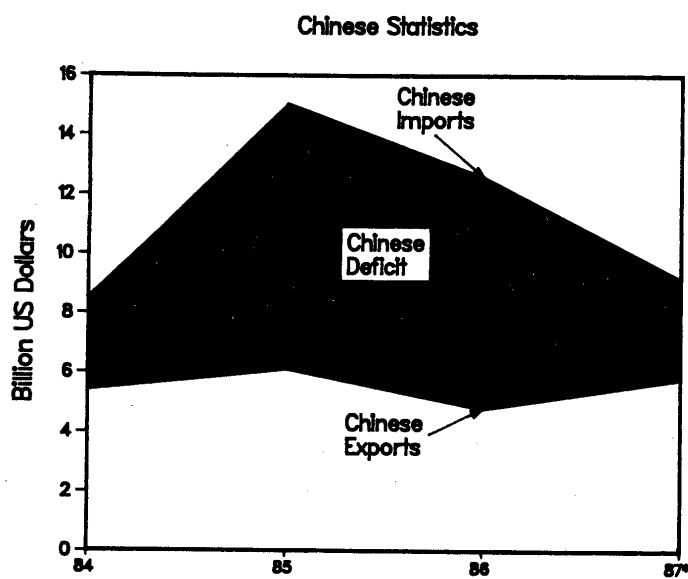
<sup>1</sup> A variety of factors account for the difference in Chinese and Japanese trade statistics. Beijing records exports through intermediaries--such as Hong Kong--as exports to the colony rather than to Japan, a practice that essentially undervalues its exports to Japan. Tokyo, however, records these imports by country-of-origin. In addition, the countries' methods for reporting insurance and freight costs in the value of imports from the other partner accounts for roughly \$1.3 billion of the \$2.6 billion discrepancy in 1987. China and Japan doubtless also use different exchange rates to value trade transactions. [REDACTED]

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Figure 1  
China-Japan Trade, 1984-87



\*Projected based on data through September 1987.

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Beijing also complains that Japanese suppliers are attempting to exploit their dominance in key sectors of China's economy. This concern has prompted China, since 1985, to attempt to diversify its sources of supply--looking to US and West European suppliers for equipment and commodities supplied primarily by Japan. Although Japan's share of China's imports of steel, industrial machinery, computers, telecommunications, scientific instruments, and vehicles has declined, Beijing remains concerned about Japanese dominance of the Chinese economy in these sectors. Chinese Customs statistics indicate, for example, that Japanese suppliers still provide at least half of China's imported power generating machinery, telecommunications equipment, electric machinery and apparatus, and steel.

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### Tokyo's View

Tokyo, for its part, has taken a hands-off approach to resolving the trade imbalance, which it regards as largely a private-sector matter. Tokyo nonetheless has echoed comments of Japanese businessmen that China needs to improve its investment environment in order to attract investment that will fuel export-oriented cooperative enterprises. Japanese statistics, moreover, indicate that the imbalance was nearly erased in 1987 as a result of rising prices for Chinese oil, strong Japanese energy demand, and reduced Chinese imports. Japanese Customs statistics show a yearend surplus of only \$852 million, one-fifth the level reached in 1986.

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Countering Chinese charges of Japanese protectionism, Tokyo claims the problem lies in the low quality, poor variety, and unreliable delivery of Chinese export commodities--failings it cannot be expected to redress, although it is attempting to improve China's transportation infrastructure by providing concessional financing for port and rail construction projects. Tokyo, moreover, has shown some flexibility regarding import quotas for coal, oil, and textiles, although similar demands from Australia, South Korea, Indonesia, and other trading partners have kept quotas on Chinese products below the levels Beijing requested. Finally, in an apparent softening of its refusal to reallocate concessional project loans to support China's export industries, in October, then Prime Minister Nakasone announced plans to provide 100 billion yen (\$770 million) in official development assistance to China's export industries.

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Tokyo demurs to the Chinese charges of market domination and disruption, citing Chinese purchasing decisions as responsible for the market position of Japanese suppliers.

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**Renewed Efforts to Curtail Purchases from Japan**

Proscriptions against importing from Japan have become an important lever Beijing has used to press Tokyo to make concessions on a variety of economic--as well as political--issues.<sup>2</sup> China banned imports of Japanese vehicles in May [redacted] and Deng Xiaoping issued more general restrictions curtailing trade and technical cooperation a month later. Deng's reasons for issuing the June directive remain unclear [redacted]

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Although these measures have applied to a variety of sectors--and Chinese officials have cited a plethora of reasons for implementing them--we believe it is no coincidence that the specific sectors in which Beijing has reportedly instructed its trade corporations to seek non-Japanese suppliers are ones in which Japan holds a majority share of China's market for imports. We suspect that Beijing may be posturing in coming up with a multiplicity of justifications for implementing measures that essentially are designed to ensure that Japan does not gain control over sectors of China's economy. [redacted]

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**Looking Ahead**

Even if China begins to show a trade surplus with Japan--a possibility we consider unlikely in the near term--Beijing will, in our view, continue to emphasize the unfavorable long-term trend in bilateral trade relations in 1988. Indeed, improvements in

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<sup>3</sup> Beijing apparently began its campaign against Japan before Tokyo tightened Japanese controls over exports of sophisticated technology to Communist countries--including China--after Toshiba Machine Company was found to have exported sensitive milling machinery to the Soviet Union. Nonetheless, trade frictions intensified in mid-1987 as Beijing publicly objected to the more restrictive Japanese policies. [redacted]

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China's balance of trade with Japan did not muffle Beijing's criticism in 1987; the Chinese press focused instead on the \$21 billion deficit that had accumulated over the 15 years since the two countries normalized relations, pointing out that China has had a deficit with Japan in all but one of those years. [REDACTED]

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In our view, Chinese officials would prefer to resolve the imbalance by increasing exports to Japan rather than by curbing China's imports from Japan, as they have been forced to do in the last two years. For this reason, Beijing will continue to press Tokyo to reduce import tariffs and to increase purchases of key commodities such as coal, oil, and cotton under annual trade agreements. Cognizant that the task of raising exports to Japan requires improvements in the production and marketing of Chinese export commodities as well, Beijing will also continue to seek Japanese investment and concessional financing for export-oriented Chinese enterprises. [REDACTED]

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Although we expect Beijing to continue to underscore the lopsided nature of bilateral economic relations, the harshness of the rhetoric--as well as the strictness with which Beijing enforces trade restrictions against Japan--will depend to a very great degree on the attitudes of key Chinese leaders toward Japan and specifically toward the Takeshita administration. Beijing's reissuance of central directives curbing trade with Japan in mid-October and in December suggests that Beijing was not "bought off" by the 100 billion yen loan to export-generating Chinese projects announced by Prime Minister Nakasone shortly before he left office. Nor did Tokyo's efforts in late 1987 to lessen the impact of tighter Japanese controls on exports of advanced technology to Communist countries allay Beijing's concerns about Japanese technology transfer policies. The December ban suggests that Beijing will deal as firmly and uncompromisingly with the new Takeshita administration as it did with that of Nakasone. Beijing's inflexibility suggests that it considers the onus for setting relations straight in 1988 to rest on Japanese shoulders. [REDACTED]

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Prominent Chinese foreign policy analysts have indicated that they share the expectation that Sino-Japanese trade will continue to decline over the next few years. The Beijing analysts expect Chinese exports to increase with a rising yen, but believe imports from Japan will remain sluggish as Beijing enforces its restrictions. After a few years' time, two-way trade is projected to recover--and even increase--as the surge in Chinese exports to Japan enables imports also to increase. [REDACTED]

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**Implications**

**For Japanese Suppliers.** Japan's share of China's imports has been declining--across-the-board, as well as in key sectors selected by Beijing--and Japanese firms will probably continue to see their marketing efforts in China yield less-than-expected returns. A reordering of Chinese import priorities away from consumer electronics and vehicles--for which Japan had been the leading supplier--and higher Japanese sales prices from appreciation of the yen have helped squeeze Japan's share of China's imports and reduce the bilateral deficit over the last few years. Over the next few years, Beijing's anti-Japanese import measures will contribute to this trend, in our view:

- Beijing's ambitious economic modernization program will continue to fuel demand for Japanese capital goods and construction materials, which in turn will fuel persistent concern in Beijing about Japanese domination of China's economy.
- As a result, Beijing will very likely continue from time-to-time to instruct traders to avoid Japanese products, at least in sectors in which the Japanese supply a dominant share of Chinese imports.
- China's reduced dependence on Japanese suppliers in 10 of the 12 commodity categories in which Japan held a dominant share of China's imports in 1984 or 1985 indicates that attractive Japanese prices, favorable financing, and a pervasive marketing presence are not always effective in winning Chinese contracts (see inset and figure 2).

Beijing, naturally, will not halt all imports from Japan, nor will its directives be uniformly heeded at the provincial or municipal level, where exhaustive marketing efforts and concessional financing may still win contracts. Moreover, even though enforcement of many of the anti-Japanese import policies would further reduce Japan's market share in China, we believe Japan will remain one of China's foremost suppliers of industrial goods--especially high-technology goods where there are few alternate suppliers.

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**And for US Exporters.** We anticipate that although the US share of China's imports may increase moderately over the next few years, such increases will reflect primarily improved export prices resulting from the dollar's decline, rather than the tensions in the Sino-Japanese economic relationship. For the most part, non-US suppliers appear to be benefiting more than US suppliers from Beijing's efforts to redirect trade away from Japan. From 1985 through September 1987, the US share of China's imports declined slightly, from 12 percent to 10 percent. During the same period, imports from countries other than Japan and the United States rose from 52 percent to 66 percent. West Germany has been the greatest beneficiary of Sino-Japanese trade frictions. The Soviet Union will also likely grab an increased share of China's imports of steel and power generating equipment as deliveries from recently signed contracts begin.

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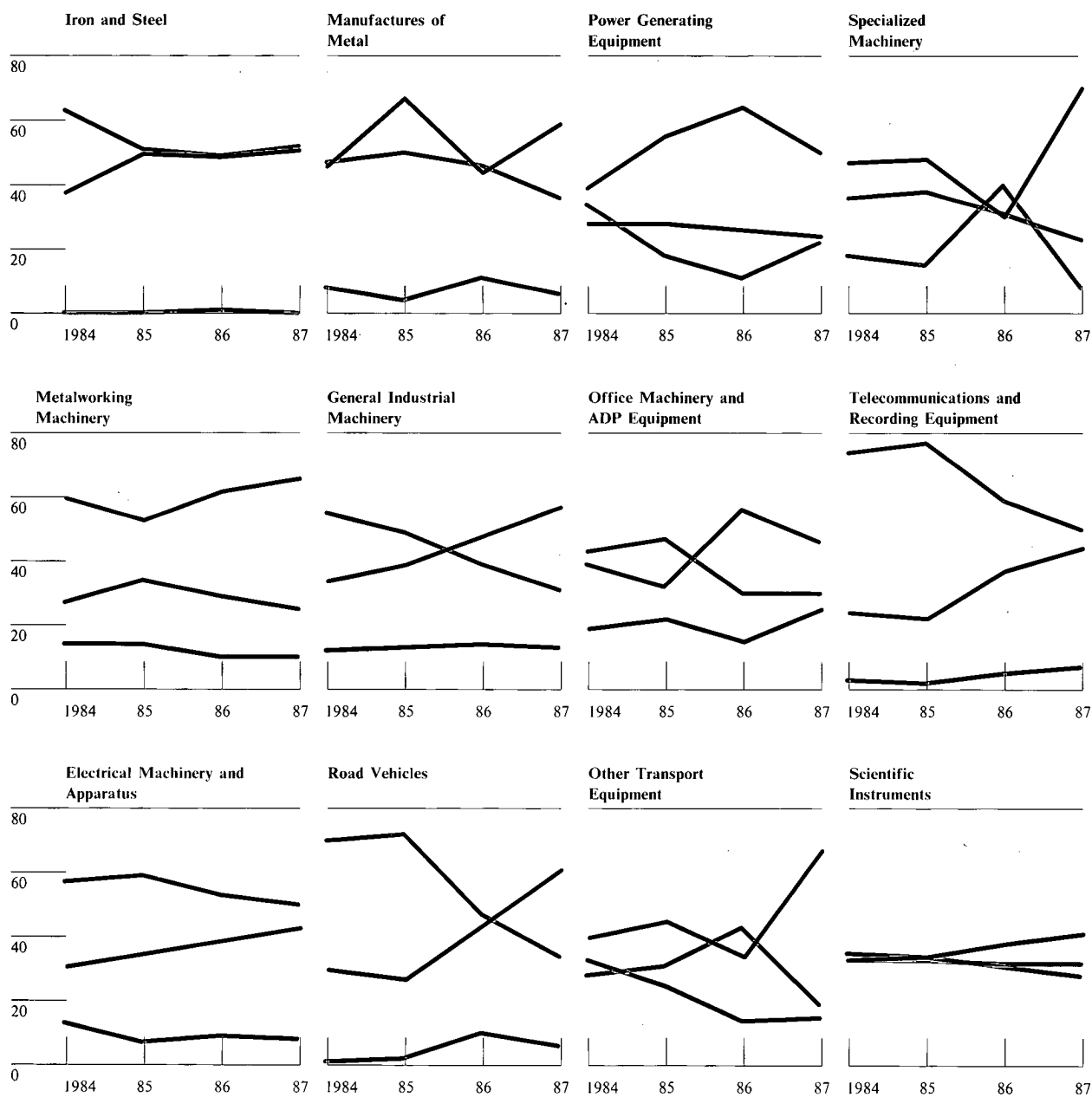
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**Figure 2****Chinese Imports:****Market Share Trends in Selected Sectors, 1984-87<sup>a</sup>**

Percent

— Japan  
— United States  
— Other

<sup>a</sup> January through September 1987.

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The US share of China's imports has increased in only three of the 10 categories in which Japan's has dropped:

- In two of the three categories in which US firms have picked up market share--computers and automated data processing equipment, and telecommunications and sound recording equipment--we suspect that the streamlining of US export controls has had a greater impact on the US market position than Beijing's anti-Japanese import directives.
- In the remaining category, road vehicles, Beijing's instructions probably contributed to the slight increase in the US market presence, but helped non-US suppliers even more; the US share increased from 2 percent in 1985 to 6 percent in the first three quarters of 1987, but suppliers from other countries increased their share of China's vehicle imports from 26 percent to 60 percent. Moreover, the increase in the US market share is of questionable importance, because China has sharply curbed its total purchases of road vehicles, and the dollar value of US road vehicle exports to China has actually declined.

Balancing these modest gains in market share is the fact that the US share of China's imports actually declined in an equal number of product lines.

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**Who Has Benefited from Japan's Lost Market Share in China?**

<u>Sectors in Which Japan Held a Dominant Share of China's Imports in 1984 or 1985</u>	<u>Has Japan's Share Declined Significantly Since Then?</u>	<u>Which Countries Increased Their Market Share Significantly?</u>
Iron/Steel	Yes, from 63% to 52%	West Germany, USSR
Metal Manufactures	Yes, from 50% to 36%	Various, primarily West European
Power Generating Equipment	No, but a 14% drop from 1986 to 1987 followed two years of increase	Japan through 1986; the <b>United States</b> in 1987; Soviet share likely to increase 1988-90
Specialized Machinery	Yes, from 36% to 23%	West Germany, Hong Kong
Metalworking Machinery	Yes, from 34% to 25%	West Germany
General Industrial Machinery	Yes, from 55% to 31%	West Germany
Office Machinery/ADP Equipment	Yes, from 45% to 31%	<b>United States</b> , West Germany
Telecommunications/Recording Equipment	Yes, from 77% to 50%	<b>United States</b> , Hong Kong
Electric Machinery/Apparatus	Yes, from 59% to 50%	Various, primarily West European
Road Vehicles	Yes, from 72% to 34%	<b>United States</b> , West Germany
Aircraft and Other Transport Equipment	Yes, from 33% to 15%	Various, primarily West European
Scientific Instruments	No	

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